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UNCLAS SECTION 01 OF 05 BANGKOK 000499

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STATE FOR EAP/MLS AND EB
TREAURY FOR OASIA
COMMERCE FOR EAP/MAC/OKSA
PASS TO FEDERAL RESERVE SAN FRANCISCO FOR DAN FINEMAN
PASS TO FEDERAL RESERVE NEW YORK FOR MATT HILDEBRANDT
PASS TO USTR FOR WEISEL
SINGAPORE FOR SUSAN BAKER

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SUBJECT: RECENT THAI ECONOMIC POLICY - WHY?

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¶E. 06 BANGKOK 7484
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BANGKOK 00000499 001.2 OF 005

¶1. (SBU) Summary. Investor confidence in Thailand has suffered a series of shocks over the past 40 days. The introduction of more stringent capital controls effectively limiting new investment, a series of bombs in Bangkok on New Year's Eve, and proposed amendments to the Foreign Business Act (FBA), all have combined to shake both foreign and domestic confidence in the economic management capability of the current government. This has been exacerbated by the regime's failure to consult with stakeholders, rapid policy-shifts and apparent lack of concern about the short-term impact of their decisions. Despite this, most economists continue to forecast Thailand's GDP for 2007 to come in at about the same rate of growth as was achieved in 2006; 4-5 percent. Despite the benefits of a decline in oil prices and continued strength in Thailand's export markets, the perception that the current government is economically and politically inept will likley cause Thailand's economy to underperform, especially in comparison to its regional competitors. End Summary.

¶2. (U) On January 17 the Monetary Policy Committee (MPC) of the Bank of Thailand (BoT) announced a 19 basis point reduction in the central bank's interest policy rate to 4.75 percent (the 1-day repurchase agreement rate which replaced the previous policy benchmark based on the 14 day repo). The reason given by the MPC for their action was "Latest economic indicators point towards a slowdown in domestic demand. In particular, consumption and investment...showed a continued moderation. On the other hand inflationary pressures are expected to moderate..."

¶3. (SBU) As we have reported (reftels), economists have been predicting for over a year that domestic demand and private

investment would grow only modestly in 2006, and they were proven correct with these indicators growing at about 3 percent and 2.9 percent respectively. The only driver to the economy was the export sector which grew about 16 percent in US$ terms. With the 14 percent appreciation in the baht last year, however, the effective contribution of exports to economic growth was much less but still was sufficient to achieve a 4.6 percent increase in GDP for the year.

Confidence Lagging

¶4. (SBU) The reasons for the poor consumer and investor confidence in 2006 were a combination of the political turmoil in the run-up to the September coup, concerns about an economic slowdown in Thailand's major export markets, and the high price of oil in an economy that imports all its crude oil and is highly energy inefficient. The coup initially provided a lift to sentiment since it was seen as resolving the political unrest and providing a clear path to new elections along with a technocratic government that would formulate economic policy untainted by political and corruption-related factors.

¶5. (SBU) In fact, the economic mood in Thailand is now quite negative. Offsetting the good news of the recent moderation of oil prices has been a series of policy decisions, along with the New Year's Eve bombings, that are widely seen to have been either badly managed, politically motivated, or both. The military-installed government is under growing criticism for not yet bringing any corruption charges against former PM Thaksin, for heavy-handed efforts to intimidate the media, and a general air of ineptitude.

Capital Controls - Why so "Draconian"?

¶6. (SBU) There is little doubt that Thai exporters' margins were under severe pressure from the appreciating baht before new capital controls were implemented on December 19. Even those who supported the measures at the time now seem to be having second thoughts about the magnitude of the BoT response to the problem, terming the measures "draconian" and "using a sledge hammer to kill a fly". Financial market participants with whom we have spoken, including Stock Exchange of Thailand management, bemoan the "clear lack of understanding of how markets work" within the BoT and the failure to consult with market participants beforehand. An SET senior official told us "we are officials charged with running the stock market, yet they (BoT) never bothered to ask us what might happen when they put in their measures because they don't trust us. Actually, they don't trust markets." Similar criticisms were directed at Deputy PM (and former BoT Governor) Pridiyathorn. The CEO of a major stock broker said "what sort of policy do you expect from a regulator"? Pridiyathorn did not help his case when he announced that the market's steep decline in the wake of the capital controls announcement was "illogical."

¶7. (SBU) Senior officials at the BoT continue to insist that they had no choice but to act as they did; arguing that they could not segregate capital flows and so had to apply the reserve requirement to all incoming capital (a policy quickly reversed for equities and that has been slowly and quietly liberalized on a continuing basis. Many believe that the controls will be mostly lifted within another month). Deputy Governor Atchana, when asked why the BoT did not try and use interest rate reductions as a first step to reduce baht appreciation replied that the Bank was concerned about the Ministry of Commerce lifting price controls on about 100 controlled items and what such an action might do to inflation. She also argued that more severe action was needed to drive out the speculators considered to be the cause of the rapid baht appreciation and cutting rates "was just what

the speculators want us to do. Why should we reward them." Several observers told us that Pridiyathorn's philosophy is that speculators only respond to "severe punishment" and that over time, markets always revert to their underlying value regardless of short-term shocks.

¶8. (U) The SET was the worst performing stock market in Asia in 2006, down about 4.8 percent for the year. Even before the capital controls were put in place, the market still underperformed its regional competitors, up only 3.5 percent through the end of November on the back of foreign investors buying over net US$2 billion (Thais were net sellers throughout the year). Over the past month, the SET has declined 9 percent while Asia ex Japan has appreciated 3 percent. In spite of recent polices, foreigners have sold only a net US$700 million of their Thai equity holdings. Reasons given for this are 1) long-term funds are content to maintain their exposure to Thailand to be in line with the MSCI global index benchmark, 2) with limited liquidity in the market, funds were concerned about moving the market further if they attempted to sell too quickly and 3),hedge funds have come back into the market over the past week expecting a bounce-back because the market is seen as being unusually cheap. As an indication of the lack of trading volume, year-to-date foreigners were net buyers of US$206.3 million in equities and contributed 42.1 percent of total market turnover.

No Keeping the Baht Down

¶9. (SBU) Some local observers believe that the BoT analysis of the causes of the baht's appreciation was both overly simplistic in blaming the problem on "speculators" and not simplistic enough given the increasing current account surpluses in the last half of the year. Some note that, despite BoT rules requiring exporters to remit all their export earnings and convert them to baht within 14 days of payment, many kept US$ accounts overseas funded (contrary to BoT regulations requiring all export earnings to be remitted

and converted into baht within 14 days) by a portion of their earnings. With the accelerating decline of the dollar, there was a rush in the last quarter of 2006 for Thais to stem the depreciation of these holdings and convert to baht. Several bankers have told us that their exporter clients had an insatiable demand for baht every time the US$ had even a small rebound and that this accelerated the baht's rise.

¶10. (SBU) Further exacerbating the baht's strength was the practice of some multinationals (especially Japanese) to undercapitalize their Thai operations and then fund them through intra-company loans. By doing so, the local operation would remit interest payments to the parent with only a 15 percent withholding tax and no problems from the BoT for the remittance (as opposed to occasional problems receiving BoT approval for remitting surplus capital). This practice also reduces the Thai operation's profitability, and therefore the amount due the Thai taxman under the 30 percent corporate tax rate. Many of these companies also participated in the Japanese carry trade; borrowing at about 30 basis points in Japan to fund their Thai operation, plus some extra to invest in RTG short-term debt to earn 5 percent which would then be sent back to the parent as part of their debt repayment. This prompted the BoT to include intra-company loans under their new reserve regulations with the effect that now many local operations of multinationals must either prove to the BoT that the loans really are for operating purposes (a cumbersome process) or borrow from local banks at considerably higher interest rates.

¶11. (SBU) In any case, the result has been the baht stabilizing at around 36/1USD but has caused the cost of capital to increase by about 30 basis points and liquidity on the capital markets to decrease. Bankers here tell us that a

significant amount of baht trading now takes place in Singapore and that there is a wide spread (about 1 baht) between offshore and onshore baht/US$ exchange rates. Bank liquidity, while more than adequate for the larger banks, will be impinged by the application of International Accounting Standard 39 by the BoT. This rule requires Thai banks to set aside more collateral for non-performing loans, a rule that some of the less-well capitalized Thai banks will have to stretch to comply with. All this has acted as a further brake on Thai business' impetus to invest more in their operations. Exacerbating that reluctance has been the proposed amendments to the Foreign Business Act.

Foreign Business Act - So Many Questions...

¶12. (SBU) As has been reported (reftels), there remains considerable uncertainty about the final form of the proposed FBA amendments and how they will be implemented. We have been told by several sources that the amendments as drafted by the Ministry of Commerce would have opened several service sectors to unlimited foreign ownership but that, after considerable cabinet debate, the amendments focused on extending the definition of an alien corporation to include as a measure voting rights (as well as share ownership) controlled by non-Thais, to increasing penalties for non-compliance, and to offer the possibility of receiving a license to continue operating and shareholder structures for some existing businesses that in future will not be permitted.

¶13. (SBU) At a time when private investment is moribund and FDI is down by more than half from 2005, less than one month after investor sentiment was why wounded by the promulgation of the capital control regulations and only weeks after the New Year's Eve bombings, why would the RTG choose this time to propose new laws restricting new foreign investment and threatening some existing investors with the retroactive aspects of the proposed amendments? If we take at face value the RTG's claim that they are simply "closing loopholes to the existing law", the questions arise of why they 1) didn't first charge and try companies with violating the FBA under existing law and 2) why they didn't consult with the foreign

business community before making the changes?

¶14. (SBU) It is privately acknowledged by the Deputy PM and widely understood in Thai society that the real reason for the amendments is that there is a political imperative to find the Shin Corp-Temasek transaction illegal. Despite the fact that former PM Thaksin has already received US$1.9 billion for the shares he and his family sold in the transaction (now mostly residing in accounts at Siam Commercial Bank and Krung Thai Bank where they are closely monitored to ensure no funds are transferred abroad) and there are no Thai laws that make the seller of an asset responsible for ensuring the buyer complies with FBA regulations, the current government is anxious to show that this transaction was illegal in order to "prove" the corrupt nature of the former PM but are apparently unable to do so under the present FBA. However, if this is the only reason to amend the FBA, the government could have amended the National Telecommunications Act, the law which governs all aspects of that sector including limits on foreign equity participation, rather than the more general FBA.

...And So Many Answers

¶15. (SBU) The answer to this question as provided by DPM Pridyathorn was that, because the current FBA (and Telecom Act) lack an effective definition of the term "nominee", and it was through the use of nominees holding shares on behalf of Temasek that the Singapore company worked around the 49 percent limit on foreign ownership of Thai telecom companies,

it would be up to a court to provide a definition of the term. Rather than "the nightmare" of leaving such a definition to the court and then having it apply to all nominee structures in Thailand, Pridiyathorn argues that his government has taken the initiative to better define legal and illegal structures and to offer a way forward for most existing companies that might fall afoul of the amendments. He has said that by providing a better law, foreigners in the future will know what they can or can not do in Thailand and, as a result, Thailand will attract more FDI. Unfortunately, the fact that the term "nominee" remains undefined means there remains considerable scope for imaginative lawyers to find ways around the new restrictions. It also means that companies will not necessarily know if they are violating the new law or not. We believe that one reason "nominee" is left ill-defined is because many Thai companies and families get around non-FBA restrictions on ownership (especially laws limiting a person to 5 percent shareholding in a commercial bank or cross-holdings between banks and non-financial companies) through the use of nominees.

¶16. (SBU) As is often the case in Thailand, there are various stories to explain that which is difficult to understand. We have been told, for instance, that a major Thai conglomerate with interests in telecom and retail has sought the FBA restrictions as a way to further their current market position and limit future competition. The quid pro quo will be that the group will help finance a marketing campaign for a positive vote on the referendum required for approval of the constitution currently being drafted. This is a response to the RTG concern that Thaksin will use his funds to finance a "no" vote campaign against the new constitution.

¶17. (SBU) While there may be some truth to the story, we find it more likely that the recent moves of the interim government directed at foreign interests are primarily moves by the traditional Thai elite reasserting control over the Thai economy. Following the Asian financial crisis and Thaksin's policies that had the potential to significantly liberalize the services sector, these recent laws and regulations are a reaction to the perceived further potential loss of Thai-elite control over critical aspects of the Thai economy. It probably is a safe bet that the current government would never have negotiated the 1994 GATS agreement, with its phased liberalization of the retailing and telecoms sectors, and is looking for a way to duck its

GATS commitments or at least minimize their practical impact. The moves are also part of the general roll-back of all things Thaksin-related. In the minds of the elite, these actions are not considered anti-foreign. They are considered as protection against the vagaries of foreign capital and the assurance that such critical sectors as telecom, banking and transport remain under Thai control and, therefore, are managed for the long-run good of Thailand (as opposed to the "short-term interests of foreigners who tend to focus on quarter-quarter financial results"). There may have been a desire to liberalize less critical sectors; architectural services, advertising or restaurants, for example. But the political capital needed to liberalize some and not other sectors would cost more than the government was willing to pay.

What Next?

¶18. (SBU) Most foreign businesses that are here will stay here despite the increased policy uncertainty. Many note that the BoT has already considerably softened its capital control rules and expect that there will simply be a new series of loopholes when the FBA is promulgated. New investment will also continue for sectors in which Thailand is most competitive, especially automotive and tourism. But in other sectors where Thailand is growing increasingly uncompetitive or if there is less reliance on existing investment, new

investment is increasingly going to go elsewhere. An example of this thinking is a US technology company with factories in Thailand, Malaysia and Taiwan in addition to the US. A new plant was destined for Thailand but, following the coup and then the capital controls, the decision was made to put the investment into Malaysia. As the regional manager told us, "even though the capital controls and FBA won't affect us, why should we put additional money into Thailand when we can't see what the political system is going to be a year down the road and the current government seems uninterested in what the foreign community thinks."

¶19. (SBU) Most economists here predict 4-5 percent GDP growth for 2007. When asked to explain how that can be when domestic consumption, private investment and exports are all forecast to grow at a lower rate than in 2006 when 4.6 percent growth was achieved, they point to anticipated increase in government spending. Given the fact that increased disbursements are unlikely until Q3 this year, the impact of government spending on GDP growth for the year as a whole will be marginal. The confidence in continued 4-5 percent economic growth is based on faith that this is the nation's "natural" rate of expansion. And no matter how poor government policy may be, as long as private companies have the financial flexibility to operate and the exchange rate remains competitive to that of Thailand's competitors, the country will grow at its "natural" rate, regardless of what most long-term foreign investors do. We agree that the Thai economy has underlying strengths that probably will prevent 2007 GDP growth from falling much below 3 percent. If the stock market is a forecaster of future economic events, it is projecting a weak performance for Thailand this year.
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